UNIVERSITY OF SWAZILAND

DEPARTMENT OF ACCOUNTING

MAIN EXAMINATION QUESTION PAPER

DEGREE/YEAR OF STUDY	:	B COM IV
TITLE OF PAPER	:	AUDITING 2
COURSE CODE	:	AC 418
TOTAL MARKS	:	100 MARKS
TIME ALLOWED	:	THREE (3) HOURS
INSTRUCTIONS	1.	TOTAL NUMBER OF QUESTIONS ON THIS PAPER: FOUR (4)
	2.	ANSWER ALL QUESTIONS
	3.	WHERE APPLICABLE ALL WORKINGS SHOULD BE SHOWN
	4.	ALL CALCULATIONS ARE TO BE MADE TO THE NEAREST LILANGENI.

NOTE: YOU ARE REMINDED THAT IN ASSESSING YOUR WORK, ACCOUNT WILL BE TAKEN OF ACCURACY OF THE LANGUAGE AND THE GENERAL QUALITY OF EXPRESSION, TOGETHER WITH THE LAYOUT AND PRESENTATION OF YOUR FINAL ANSWER.

SPECIAL REQUIREMENT: NONE

THIS PAPER IS NOT TO BE OPENED UNTILL PERMISSION HAS BEEN GRANTED BY THE INVIGILATOR.

QUESTION 1

(a) Explain the purpose of a management representation letter. (5 marks)

(b) You are the manager in charge of the audit of Cheetah, a public limited liability company which manufactures specialist cars and other motor vehicles for use in films. Audited turnover is $140 million with profit before tax of $7·5 million.

All audit work up to, but not including, the obtaining of management representations has been completed. A review of the audit file has disclosed the following outstanding points:

Impala

The company is facing a potential legal claim from the Impala company in respect of a defective vehicle that was supplied for one of their films. Impala maintains that the vehicle was not built strongly enough while the directors of Cheetah argue that the specification was not sufficiently detailed. Dropping a vehicle 50 metres into a river and expecting it to continue to remain in working condition would be unusual, but this is what Impala expected. Solicitors are unable to determine liability at the present time. A claim for $4 million being the cost of a replacement vehicle and lost production time has been received by Cheetah from Impala. The director's opinion is that the claim is not justified.

Depreciation

Depreciation of specialist production equipment has been included in the financial statements at the amount of 10% pa based on reducing balance. However the treatment is consistent with prior accounting periods (which received an unmodified auditor's report) and other companies in the same industry and sales of old equipment show negligible profit or loss on sale. The audit senior, who is new to the audit, feels that depreciation is being undercharged in the financial statements.

Required:

For each of the above matters:
(i) discuss whether or not a paragraph is required in the representation letter; and
(ii) *if appropriate*, draft the paragraph for inclusion in the representation letter. (8 marks)

(c) A suggested format for the letter of representation has been sent by the auditors to the directors of Cheetah.

The directors have stated that they will not sign the letter of representation this year on the grounds that they believe the additional evidence that it provides is not required by the auditor.

Required:
Discuss the actions the auditor may take as a result of the decision made by the directors not to sign the letter of representation. (5 marks)

Neptune Enterprises Co (Neptune) manufactures and distributes fashion clothing to retail stores. Its year end was 31 March 2018. You are the audit manager and the year-end audit is due to commence shortly. The following three matters have been brought to your attention.

(i) Supplier statement reconciliations

Neptune receives monthly statements from its main suppliers and although these have been retained, none have been reconciled to the payables ledger as at 31 March 2018. The engagement partner has asked the audit senior to recommend the procedures to be performed on supplier statements.

(3 marks)

(ii) Bank reconciliation

During last year's audit of Neptune's bank and cash, significant cut off errors were discovered with a number of post year-end cheques being processed prior to the year end to reduce payables. The finance director has assured the audit engagement partner that this error has not occurred again this year and that the bank reconciliation has been carefully prepared. The audit engagement partner has asked that the bank reconciliation is comprehensively audited.

(4 marks)

Required:

(d) Describe substantive procedures you would perform to obtain sufficient and appropriate audit evidence in relation to the above two matters.

Note: The mark allocation is shown against each of the three matters above.

(25 marks)

QUESTION 2

Tiger Motoring Co (Tiger) specialises in manufacturing engine parts for motor cars and the company has a diverse customer base but seven significant customers. The company's year-end was 30 September 2017.

During the year, a number of the company's significant customers have experienced a fall in sales, and consequently they have purchased fewer items from Tiger. As a result, Tiger has paid a number of its suppliers later than usual and some of them have withdrawn credit terms meaning the company must pay cash on delivery. One of

Tiger's main suppliers is threatening legal action to recover the sums owing. As a result of the increased level of payables, the company's current ratio has fallen below 1 to 0·9 for the first time.

Tiger has produced a cash flow forecast to 30 June 2018 and this shows net cash outflows until May 2018.

Tiger has a loan of $2·3 million which is due for repayment in full by 30 September 2018.
The finance director has just informed the audit manager that there is a possible change in legislation which will result in one of Tiger's top product lines becoming obsolete as it will not comply with the proposed law. The prepared cash flow forecasts do not reflect this possible event.

Required:

(a) Explain FIVE potential indicators that Tiger Motoring Co is NOT a going concern. (5 marks)

(b) Describe the audit procedures which you should perform in assessing whether or not Tiger Motoring Co is a going concern. (5 marks)

Lion Industries Co (Lion) develops and manufactures a wide range of fast moving consumer goods. The company's year-end is 30 June 2018 and the forecast profit before tax is $8·3 million. You are the audit manager of Rabbit & Co and the year-end audit is due to commence in July. The following information has been gathered during the planning process:

Inventory count
Lion's raw materials and finished goods inventory are stored in 12 warehouses across the country. Each of these warehouses is expected to contain material levels of inventory at the year end. It is expected that there will be no significant work in progress held at any of the sites. Each count will be supervised by a member of Lion's internal audit department and the counts will all take place on 30 June 2018, when all movements of goods in and out of the warehouses will cease.

Research and development
Lion spends over $2 million annually on developing new product lines. This year it incurred expenditure on five projects, all of which are at different stages of development. Once they meet the recognition criteria under IAS 38 *Intangible Assets* for development expenditure, Lion includes the costs incurred within intangible assets. Once production commences, the intangible assets are amortised on a straight line basis over five years.

Required:

(c) Describe audit procedures you would perform during the audit of Lion Industries Co:

(i) BEFORE and DURING the inventory counts; and (10 marks)

(ii) In relation to research and development expenditure. (5 marks)

(25 marks)

QUESTION 3

(a) Barley Co (Barley) manufactures breakfast cereals and has three factories, four warehouses and three distribution depots spread across North America. The audit for the year ended 31 December 2017 is almost complete and the financial statements and audit report are due to be signed shortly. Profit before taxation is $7·9 million. The following events have occurred subsequent to the year end and no amendments or disclosures have been made in the financial statements.

Event 1 – Fire:
On 15 February 2018, a fire occurred at the largest of the distribution depots. The fire resulted in extensive damage to 40% of the company's vehicles used for dispatching goods to customers; however, there have been no significant delays to customer deliveries. The company estimates the level of damage to the vehicles to be in excess of $650,000. Only a minimal level of inventory, approximately $25,000, was damaged. Grain's insurance company has started to investigate the fire to assess the likelihood and level of payment, however, there are concerns the fire was started deliberately, and if true, would invalidate any insurance cover.

Event 2 – Inventory:
On 18 February 2018, it was discovered that a large batch of Grain's new cereal brand 'Loopy Green Loops' held in inventory at the year-end was defective, as the cereal contained too much green food colouring. To date no sales of this new cereal have been made. The cost of the defective batch of inventory is $915,000 and the defects cannot be corrected. However, the scrapped cereal can be utilised as a raw material for an alternative cereal brand at a value of $50,000.

Required:

For each of the two subsequent events described above:
(i) Based on the information provided, explain whether the financial statements require amendment; and
(ii) Describe audit procedures which should now be performed in order to form a conclusion on any required amendment.

Note: The total marks will be split equally between each event. (12 marks)

(b) Penguin Pizzas Co (Penguin) operates a large chain of fast food restaurants. You are an audit supervisor of Robin & Co and are currently preparing the audit programmes for the audit of Penguin's financial statements for the year ended 31 March 2018. You are reviewing the notes of last week's meeting between the audit manager and finance director where two material issues were discussed.

(i) Property, plant and equipment

In the past Penguin has received negative press reports over the condition of its fast food restaurants, with comments suggesting they are old fashioned and tired looking. Therefore during the year the company undertook a full review of all its assets and carried out extensive refurbishments to the majority of its restaurants. This review resulted in a significant amount of ageing fixtures and fittings being disposed of and a significant amount of capital expenditure was invested in all remaining restaurants. (8 marks)

(ii) Equity

The refurbishment was financed via a share issue in April 2017 at a premium of $1·6 million. (5 marks)

Required:

Describe substantive procedures you should perform to obtain sufficient and appropriate audit evidence in relation to the above two matters.

Note: The mark allocation is shown against each of the two matters above.

(25 marks)

QUESTION 4

Cindy Co manufactures women's clothing and its year end was 31 March 2018. You are an audit supervisor of Sam & Co and the year-end audit for Cindy Co is due to commence shortly.

The draft financial statements recognise profit before tax of $2·6m and total assets of $18m. You have been given responsibility for auditing receivables, which is a material balance, and as part of the audit approach, a positive receivables circularisation is to be undertaken.
At the planning meeting, the finance director of Cindy Co informed the audit engagement partner that the company was closing one of its smaller production sites and as a result, a number of employees would be made redundant. A redundancy provision of $110,000 is included in the draft financial statements.

Required:

(a) **Describe the steps the auditor should perform in undertaking a positive receivables circularisation for Cindy Co.**

(6 marks)

(b) Describe substantive procedures, other than a receivables circularisation, the auditor should perform to verify

EACH of the following assertions in relation to Cindy Co's receivables:

(i) Accuracy, valuation and allocation;
(ii) Completeness; and
(iii) Rights and obligations.

Note: The total marks will be split equally between each part. (9 marks)

(c) Describe substantive procedures the auditor should perform to confirm the redundancy provision at the year end.

(5 marks)

A few months have now passed and the audit team is performing the audit fieldwork including the audit procedures which you recommended over the redundancy provision. The team has calculated that the necessary provision should amount to $305,000. The finance director is not willing to adjust the draft financial statements.

Required:

(d) Discuss the issue and describe the impact on the auditor's report, if any, should this issue remain unresolved.

(5 marks)

(25 marks)

End of Question Paper